Banks
Development Banks
Sri Lanka

Housing Development Finance Corporation Bank of Sri Lanka

Key Rating Drivers

Standalone Strength Drives Rating: Housing Development Finance Corporation Bank of Sri Lanka's (HDFC) National Long-Term Rating is highly influenced by the difficult operating environment, and reflects the bank's high risk appetite. Its weaker-than-average asset quality stems from its large exposure to low- and middle-income customers, who are particularly susceptible to economic and interest-rate cycles. The rating also captures HDFC's limited access to capital markets and small franchise in the domestic banking sector.

Challenging Operating Environment: Fitch Ratings expects the performance of Sri Lankan banks, including HDFC, to come under stress from the increasingly challenging operating environment. We forecast Sri Lanka's GDP to contract by 3.7% in 2020. Key credit metrics are likely to continue weakening, consistent with our previous expectation, despite regulatory relief.

Elevated Asset-Quality Risk: HDFC's asset quality is likely to deteriorate, similar to our view on the sector, as the economic downturn arising from the coronavirus pandemic hinders borrowers' ability to service their loans. HDFC's impaired-loan ratio – based on stage III loans, which include loans backed by the Employee Provident Fund (EPF) that are in arrears – stood at 25% at end-2019 (end-2018: 24%), higher than the peer average of 12%.

We believe that the current asset-quality deterioration, while significant, has not fully captured the impact of the economic disruption, as regulatory relief in the form of loan-repayment moratoriums and loan restructuring has temporarily halted the recognition of credit impairments.

Pressure on Profitability: We expect HDFC's provisions against coronavirus-related credit losses to increase in the next few quarters, which, combined with weaker business volumes, is likely to intensify pressure on profitability. However, HDFC's profitability is higher than that of peers, with operating profit/risk-weighted assets averaging 4.0% between 2016 and 1H20 (peer average: 2.2%), benefiting from zero risk weights from EPF-backed loans. HDFC's average return on assets of 1.0% in 2016-1H20 is better than the peer average of 0.6%.

Capital Vulnerable to Moderate Shocks: HDFC's relatively small capital base and its limited access to capital compared with higher-rated large commercial bank peers exposes the bank's capitalisation to profitability and asset-quality shocks. This is despite HDFC's common equity Tier 1 ratio of 17.1% at end-1H20, which is above that of its peers (peer average of 14.6% and the sector's 11.9%).

Concentrations Raise Liquidity Risk: We expect HDFC's high asset and liability mismatches to persist due to its longer-tenor loan book and short-tenor deposit base, while high deposit concentration could also exert pressure on liquidity in the medium term. Nonetheless, we do not expect pressure on HDFC's rupee liquidity in the near term as liquidity has been made available by the reduction in the statutory reserve ratio and the Central Bank of Sri Lanka's other accommodative monetary policies.

Rating Sensitivities

Rating Upgrade Unlikely: Positive rating action is unlikely in the near term due to the challenging operating environment. In the longer term, an upgrade is contingent on a sustained improvement in HDFC's credit profile relative to the universe of Sri Lankan-rated entities. Improved asset quality and market share, while maintaining adequate capital buffers commensurate with a high risk appetite, would be consistent with positive rating action.

Significant Capital Erosion: HDFC's rating could be downgraded if capital buffers were to be substantially eroded due to weakening asset quality, higher unprovisioned impaired loans, or prolonged rapid growth in the more vulnerable customer segments.Click here to enter text.

Ratings

National	
National Long-Term Rating	BB+(lka)
Sovereign Risk	
Long-Term Foreign-Currency IDR	B-
Long-Term Local-Currency IDR	B-
Country Ceiling	B-

Outlooks

National Long-Term Rating	Stable
Sovereign Long-Term Foreign-Currency IDR	Negative
Sovereign Long-Term Local-Currency IDR	Negative

Applicable Criteria

Bank Rating Criteria (February 2020)
National Scale Rating Criteria (June 2020)

Related Research

Operating Environment for Sri Lankan Banks Deteriorates (July 2020)
Coronavirus Compounds Sri Lankan Banks' Stresses (June 2020)
Sri Lankan Banks' Risks to Persist Despite Regulatory Measures (April 2020)

Financial Data

Housing Development Finance Corporation Bank of Sri Lanka

	30 Jun 20	31 Dec 19
Total assets (USDm)	320.8	308.1
Total assets (LKRm)	59,735.5	55,954.6
Total equity (LKRm)	5,453.4	5,119.1

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Company Summary

HDFC is a small state-owned Licensed Specialised Bank (LSB) that engages mainly in housing financing as part of its quasi-development role to supports the state's National Housing Policy. The bank accounted for 0.4% of sector assets at end-June 2020, and operates with 39 branches. We expect HDFC to remain focused on housing financing as its main line of business, although the share of which has gradually come down to 79% by end-1H20 from 85% at end-2015. HDFC has shown a bigger appetite to lend towards leasing, SME and mid-sized corporates, in order to reduce its high concentration on housing financing.

We believe sovereign's timely support to HDFC cannot be relied upon, given the Sri Lankan sovereign's weak ability, as reflected in its low rating of B-/Negative, and HDFC's less systemic importance compared with large state banks. This is despite the state of Sri Lanka's indirect shareholding of 51% of HDFC's issued capital through the National Housing Development Authority (49.7%), Urban Development Authority (0.5%) and State Engineering Corporation (0.2%).

As an LSB, HDFC is not allowed, by regulation, to accept demand deposits, and therefore has a relatively high cost of funds. This limits its ability to compete with mainstream commercial banks for better-quality credits.

Key Latest Developments

Asset Quality

HDFC's regulatory non-performing loans (excluding EPF loans in arrears) spiked to 19.6% of gross loans by end-1H20 from 13.7% at end-2019, which is substantially higher than the sector's 5.3%, and reflects the concentration of its credit risk in the low- and middle-income housing-finance market. Loan-loss coverage was low and only adequate to cover around 10% of impaired loans in 2018-1H20, reflecting HDFC's high share of EPF and residential housing-backed lending.

Earnings and Profitability

HDFC's pre-impairment operating profit (PPOP)/average loans declined to 3.7% by end-1H20, from 3.9% at end-2019, narrowing its ability to absorb credit-cost shocks. Its loan-impairment charges widened in 1H20 equivalent to 91bp of loans on an annualised basis (2019: 66bp), absorbing 24% of pre-impairment operating profit (2019: 21%), which is line with the peer median of 100bp.

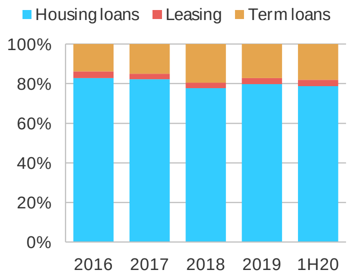
Capitalisation and Leverage

We estimate that HDFC would require additional capital of around LKR2.4 billion to meet the enhanced regulatory capital threshold of LKR7.5 billion by the extended deadline of end-2022, which we believe the bank can meet through internal capital generation. Furthermore, HDFC's regulatory capital ratios benefit from low risk density, underpinned by EPF-backed loans and mortgage-backed housing loans which are risk-weighted at 0% and 50%, respectively.

Funding and Liquidity

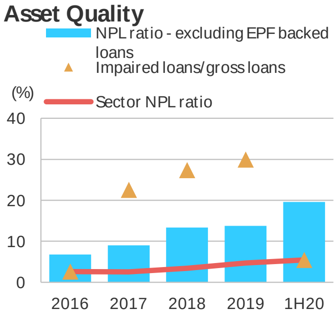
HDFC's loans-to-deposits ratio was high at 93.9% at end-1H20, but is better than the peer median of 95.7%. Deposits have been the main source of HDFC Bank's funding, with 85% of total funding at 1H20. The bank's other funding sources consist of listed debentures (around 8% of total funding at end-2019); but the bank may face challenges in rolling over the debentures due to the minimum rating requirement for listed debentures.

Loan Book Composition



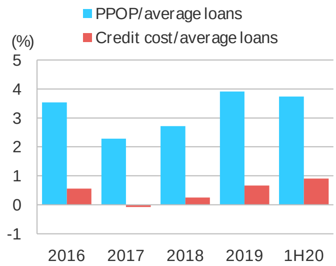
Source: Fitch Ratings, Fitch Solutions, HDFC

Asset Quality



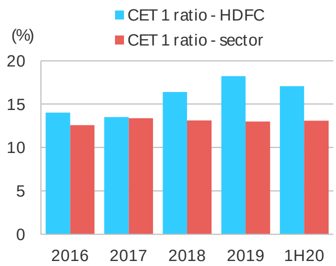
Source: Fitch Ratings, Fitch Solutions, HDFC

Profit Buffers



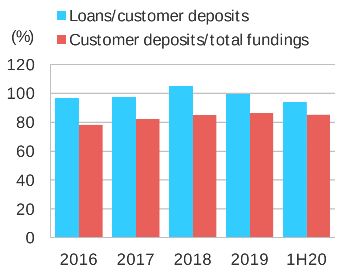
Source: Fitch Ratings, Fitch Solutions, HDFC

Capitalisation



Source: Fitch Ratings, Fitch Solutions, HDFC

Funding and Liquidity



Source: Fitch Ratings, Fitch Solutions, HDFC

Summary Financials and Key Ratios

	30 Jun 20		31 Dec 19	31 Dec 18	31 Dec 17
	6 months - interim	6 months - interim	Year end	Year end	Year end
	(USDm)	(LKRm)	(LKRm)	(LKRm)	(LKRm)
	Unaudited	Unaudited	Audited - unqualified	Audited - unqualified	Audited - unqualified
Summary income statement					
Net interest and dividend income	8	1,501.6	2,899.9	2,238.4	1,871.7
Net fees and commissions	1	112.6	358.3	380.3	347.8
Other operating income	0	-1.8	48.9	57.8	12.0
Total operating income	9	1,612.4	3,307.1	2,676.5	2,231.5
Operating costs	4	815.6	1,739.8	1,668.1	1,471.9
Pre-impairment operating profit	4	796.8	1,567.3	1,008.4	759.6
Loan and other impairment charges	1	192.2	322.8	92.7	-56.8
Operating profit	3	604.6	1,244.5	915.7	816.4
Other non-operating items (net)	n.a.	n.a.	n.a.	3.0	5.0
Tax	1	270.2	768.8	354.3	407.1
Net income	2	334.4	475.7	564.4	414.3
Other comprehensive income	n.a.	n.a.	-14.5	-42.4	-43.6
Fitch comprehensive income	2	334.4	461.2	522.0	370.7
Summary balance sheet					
Assets					
Gross loans	226	42,157.8	42,359.9	38,812.1	35,734.8
- Of which impaired	n.a.	n.a.	10,673.4	9,282.7	7,158.3
Loan loss allowances	7	1,296.1	1,144.3	878.1	767.0
Net loans	219	40,861.7	41,215.6	37,934.0	34,967.8
Interbank	57	10,598.9	7,810.9	5,452.1	9,118.3
Derivatives	n.a.	n.a.	n.a.	n.a.	n.a.
Other securities and earning assets	38	7,035.0	5,819.7	4,871.2	4,736.4
Total earning assets	314	58,495.6	54,846.2	48,257.3	48,822.5
Cash and due from banks	1	267.1	150.2	244.4	167.9
Other assets	5	972.8	958.2	783.6	733.4
Total assets	321	59,735.5	55,954.6	49,285.3	49,723.8
Liabilities					
Customer deposits	241	44,899.0	42,504.3	37,016.0	36,655.0
Interbank and other short-term funding	n.a.	n.a.	n.a.	n.a.	n.a.
Other long-term funding	40	7,452.6	6,599.5	6,652.6	7,916.7
Trading liabilities and derivatives	n.a.	n.a.	n.a.	n.a.	n.a.
Total funding	281	52,351.6	49,103.8	43,668.6	44,571.7
Other liabilities	9	1,647.8	1,465.0	860.1	920.5
Preference shares and hybrid capital	2	282.7	266.7	n.a.	n.a.
Total equity	29	5,453.4	5,119.1	4,756.6	4,231.6
Total liabilities and equity	321	59,735.5	55,954.6	49,285.3	49,723.8
Exchange rate		USD1 = LKR186.2292	USD1 = LKR181.634	USD1 = LKR182.2783	USD1 = LKR152.8548

Source: Fitch Ratings, Fitch Solutions, HDFC

Summary Financials and Key Ratios

	30 Jun 20	31 Dec 19	31 Dec 18	31 Dec 17
Ratios (annualised as appropriate)				
Profitability				
Operating profit/risk-weighted assets	4.2	4.7	3.9	3.4
Net interest income/average earning assets	5.3	5.6	4.7	3.9
Non-interest expense/gross revenue	50.6	52.6	62.3	66.0
Net income/average equity	12.7	9.6	12.7	10.7
Asset quality				
Impaired loans ratio	n.a.	25.2	23.9	20.0
Growth in gross loans	-0.5	9.1	8.6	15.1
Loan loss allowances/impaired loans	n.a.	10.7	9.5	10.7
Loan impairment charges/average gross loans	0.9	0.7	0.3	-0.1
Capitalisation				
Common equity Tier 1 ratio	17.1	18.2	16.4	13.5
Fitch Core Capital ratio	n.a.	n.a.	19.1	16.7
Tangible common equity/tangible assets	8.7	8.7	9.2	8.2
Basel leverage ratio	9.0	8.9	6.7	n.a.
Net impaired loans/common equity Tier 1	n.a.	194.3	216.9	227.0
Funding and liquidity				
Loans/customer deposits	93.9	99.7	104.9	97.5
Liquidity coverage ratio	243.0	191.3	231.3	n.a.
Customer deposits/funding	85.3	86.1	84.8	82.2
Net stable funding ratio	131.0	128.5	n.a.	n.a.

Source: Fitch Ratings, Fitch Solutions, HDFC

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.